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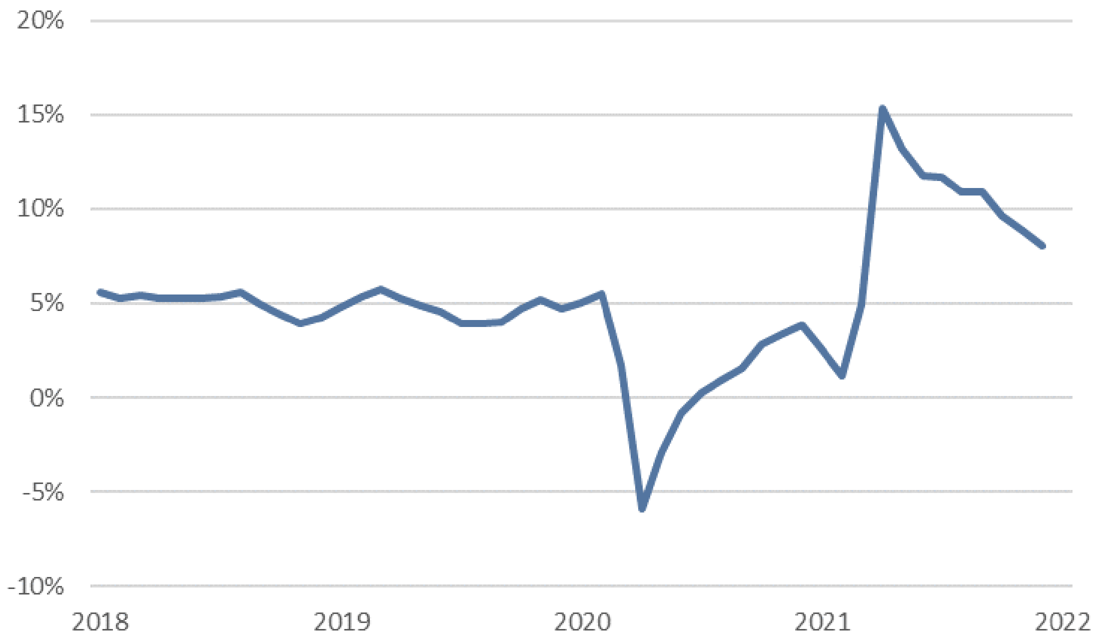
WEEKLY MARKET UPDATE
January 10, 2022

MARKET COMMENTARY

Fig. 1: Aggregate Wage and Income Growth



Source: Bloomberg, Mill Creek

At the end of last year, we asked our clients what they perceived as the biggest market risks for 2022. The top 5 survey answers were:

1. Inflation (75%)
2. Supply chain disruptions (53%)
3. Domestic politics (43%)
4. Rising interest rates (40%)
5. Tax increases (38%)
6. Equity valuations (34%)

We will spend the next few weeks covering these topics in our weekly commentary. Today, we start with inflation.

It's always reasonable to start by asking "what's priced in?" when thinking about a potential risk. This approach simplifies the analytical exercise because the question becomes whether market pricing for something is too high, too low, or fair versus likely outcomes. Participants in the US Treasury bond market have priced in 3.43% inflation over the next 12 months. Inflation swaps, another market-based measure for inflation, are pricing 3.8% Consumer Price Index (CPI) growth for 2022.

It is worth noting that the median Federal Open Market Committee (FOMC) participant expects inflation to average 2.6% in 2022 and trend back to 2.1% (effectively in line with their target) by 2024.

They forecast personal consumption expenditure (PCE) inflation, which for technical reasons tends to run below CPI inflation. An apples-to-apples comparison would be about 3% CPI in 2022. Market participants are telling the Fed that there's a disconnect between their projected policy path and their forecasts. We believe the FOMC's forecasts will be revised higher through 2022.

How do we think about inflation as a risk at the current time? One measure we focused on in 2021 was aggregate incomes. If incomes are growing by 10% and the US economy can only produce real growth of 5%, then we'll end up with inflation of 5% or so. Recent data indicates income growth has slowed to about 8% year-over-year (Fig.1), but we'll keep monitoring this closely in 2022. Inflation will remain elevated until aggregate income growth normalizes.

We'd characterize the current situation as one where the market expectation (roughly 3.5-4%) seems reasonably in the ballpark for 2022, but the distribution around that number isn't symmetric and there remain more upside risks (sustained income growth, geopolitical conflict, supply chain problems) to inflation than downside risks. If forced to pick one side we'd take the over.
Our positioning within portfolios reflects this view.

QUICK LINKS

- **Q1 2022 Outlook**
- **Year Ahead 2022: Hurry Up and Wait**
- **Mill Creek Chief Investment Officer Transition Plan**
- **House View Summary**

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